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No. 94-763

IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

FIRST NATIONWIDE BANK, a Federal Savings Bank, a Federal Stock Association,

Petitioner,

v.

GELT FUNDING CORP., *et al.*,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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BRIEF FOR THE RESPONDENTS IN OPPOSITION

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LIST OF PARTIES AND CORPORATIONS

The caption to the Petition for a Writ of Certiorari lists all the parties to the proceeding.

Pursuant to Rule 29.1, Respondent Gelt Funding Corp. states that it has no parents or subsidiaries.

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BRIEF FOR THE RESPONDENTS IN OPPOSITION

A San Francisco bank (wholly owned by Ford Motor Co.) embarked in 1985 on an ambitious lending spree to individual purchasers of New York City rental properties. After the New York real estate market collapsed in 1990, the Bank sought damages through a federal RICO action against a small mortgage brokerage firm and various real estate investors. The district court determined twice that the Bank's complaint failed to state a claim. The court of appeals unanimously affirmed. The decision below turns on the specific facts of this case and decides no novel principles of law. The petition for a writ of certiorari should be denied.

COUNTERSTATEMENT OF THE CASE

In 1985, First Nationwide Bank ("the Bank") was bought by Ford Motor Co. and launched an ambitious expansion of its lending activities in New York City (Pet. App. A-4). From 1985 to 1990, the Bank invested more than $1.3 billion in the New York real estate market by making loans to private purchasers of rental properties (*id.*). All these loans were "non-recourse" — *i.e.*, the Bank, bullish on the future prospects of the New York market, limited its recourse in case of default to the underlying properties (Pet. App. A-5). Borrowers served by Gelt Funding Corp. ("Gelt"), a mortgage broker, accounted for approximately 70 percent of the Bank's New York commercial loans (Pet. App. A-4). By 1990, the New York real estate market had collapsed, and the Bank shut down all commercial lending in New York (*id.*).

The Bank alleges that during an audit in 1991 it "discovered" that a higher proportion of Gelt loans than other loans were in default (Pet. App. A-5). Based largely on that "discovery," the Bank initiated this action under the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. §§ 1961, 1964, purportedly to redress fraud perpetrated by the respondents. [1]

The Bank filed its initial complaint in January 1992. It was dismissed on November 30, 1992, because the Bank failed to allege that it had incurred any present injury (few of the loans, in fact, were alleged to be in default) or that its injury, if any, was caused by respondents' alleged

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[1] The Bank also has filed a lawsuit in state court in New York, in which it is pursuing claims based on the same allegations contained in its federal complaint.

misstatements. The district court granted leave to amend, and the Bank then filed a 174-page complaint containing (i) a complex "methodology" for determining the values of the properties when the loans were made and (ii) equally complicated and novel theories of injury and causation.

In its amended complaint, the Bank theorized that respondents should be liable for the "additional risk" the Bank assumed when it loaned more money than it would have loaned but for the alleged misstatements. The Bank argued that it was irrelevant whether it foreclosed on the properties or even had other creditor remedies because "[f]or all practical purposes, the . . . additional funds were lost the moment the loans were made" and are "recoverable even if the borrower repaid the loan in full with interest" (Pet. App. A-8, A-9). The Bank also alleged that respondents are liable for reserves it took against projected losses on the Gelt loans, which diminished the Bank's capital and drained its "life's blood" (Pet. App. A-7).

The district court rejected the injury theory alleged in the amended complaint. The court held that the Bank had not satisfied the axiomatic rule that a plaintiff has standing only if there is actual present injury, not speculative injury that might occur in the future (Pet. App. C-6). The court also criticized, as a "prescription for ceaseless litigation" (Pet. App. C-7), the Bank's "novel" theory that "a claimant could recover under RICO for 'additional risk' it unknowingly assumed on a loan, even if the loan was repaid" (*id.*).

A unanimous panel of the Second Circuit affirmed. It concluded that the actual damages, if any, that might be incurred by the Bank were yet to be determined and were based on little more than guesswork (Pet. App. A-10). The

panel also held that the amended complaint suffered from the "equally fundamental defect" of not adequately alleging proximate cause. Among other things, respondents made payments for years on each of the loans in the amended complaint, and not a single loan went into default before the market collapsed in 1990. While the Bank's valuation "methodology" tried to brush aside the market's collapse as mere "concidence," the court of appeals concluded that "[t]he methodology employed by [the Bank] in determining the magnitude of the defendants' alleged [misstatements] is so defective, and the conclusions reached so defy logic that no 'reasonable inferences' [of proximate cause] can be drawn therefrom" (Pet. App. A-17). In short, "FNB's claims fail because it has not adequately pled facts which, if proven, would show that its loss was caused by the alleged misstatements as opposed to intervening events" (Pet. App. A-19).

ARGUMENT

I

THE SECOND CIRCUIT'S INJURY AND CAUSATION ANALYSES ARE BASED ON WELL ESTABLISHED PRINCIPLES

The Second Circuit's ripeness and proximate-cause determinations are consistent with principles announced by this Court, with other Second Circuit precedents, and with the law in every other Circuit.

A. The Complaint Failed To Allege Actual Present Injury.

The Bank argues in its petition for certiorari, as it did below, that even if it ultimately is repaid the full amount of its loans with interest, it suffered fraud losses on the day the loans were made — and must be paid treble "damages" and attorneys' fees — in the amount of the difference between what the Bank actually loaned and the amount it would have loaned had the Bank known of the alleged misrepresentations. This is an untenable argument.

The Second Circuit invoked a general rule of fraud damages applicable to lenders who claim that security has been fraudulently overvalued: "Because the fraud defendant is not liable for all losses that may occur, but only for those actually suffered, only after the lender has exhausted the bargained-for remedies available to it can the lender assert that it was damaged by the fraud, and then only to the extent of the deficiency" (Pet. App. A-9). This established principle is supported by ample precedent. *E.g., Disher v. Information Resources, Inc.*, 691 F. Supp. 75, 79 (N.D. Ill. 1988), *aff'd*, 873 F.2d 136 (7th Cir. 1989); *Hermes v. Title Guarantee & Trust Co.*, 282 N.Y. 88, 93, 24 N.E.2d 859, 861 (1939); *Sager v. Friedman*, 270 N.Y. 472, 480-81, 1 N.E.2d 971, 973-74 (1936).

The Bank's theory conflicts with the fundamental principle that "to the extent the plaintiffs received the return actually bargained for, they had suffered no compensable RICO injury" (Pet. App. A-11). The courts below correctly rejected the Bank's liability theory as a "prescription for ceaseless litigation" by lenders, investors, and others who, despite receiving everything they bargained for, assert under RICO and other fraud theories that they would have

bargained a better deal but for misstatements by their co-parties (Pet. App. C-7).

There is no conflict between the decision below and the Seventh Circuit's decision in *Federal Deposit Ins. Corp. v. W.R. Grace & Co.*, 877 F.2d 614 (7th Cir. 1989), *cert. denied*, 494 U.S. 1056 (1990). *W.R. Grace Co.*, which did not involve RICO claims, concerned an unsecured loan that was repayable solely out of revenue generated from three gas fields. When the bank learned that the fields contained no gas, the loans became totally worthless. It was, therefore, incontestable that the bank had lost the amount of its loan. Similarly, in *Greycas, Inc. v. Proud*, 826 F.2d 1560 (7th Cir. 1987), *cert. denied*, 484 U.S. 1043 (1988), the plaintiff sued *after* the collateral had been sold and the fact and extent of its injury had been established. And in *Sager v. Friedman*, 270 N.Y. 472, 481, 1 N.E.2d 971, 974 (1936), the court held that amounts paid on the debt reduced the amount the plaintiff could claim as fraud damages.

The Second Circuit's ripeness analysis also follows earlier rulings of that court. *E.g., Stochastic Decisions, Inc. v. DiDomenico*, 995 F.2d 1158, 1166 (2d Cir.), *cert. denied*, 114 S. Ct. 385 (1993); *Bankers Trust Co. v. Rhoades*, 859 F.2d 1096, 1106 (2d Cir. 1988), *cert. denied*, 490 U.S. 1007 (1989).

In *Stochastic Decisions*, the Second Circuit held that a plaintiff's damages were not ripe because there were ongoing efforts on the plaintiff's part to collect judgments (995 F.2d at 1165). And in *Bankers Trust*, the court held that a bank's injury was contingent upon default and a subsequent sale of collateral. *Bankers Trust* and *Stochastic* have been relied upon repeatedly by courts in other Circuits,

and the petitioner does not cite in this Court any authority disagreeing with the holdings in those cases.

B. The Alleged Fraud Did Not Proximately Cause the Bank's Injury.

The Second Circuit analyzed the Bank's proximate-cause allegations under the well-settled rule that a RICO plaintiff must allege "that the defendant's violations were a proximate cause of the plaintiff's injury, *i.e.*, that there was a direct relationship between the plaintiff's injury and the defendant's injurious conduct." *See* Pet. App. A-11 (quoting *Standardbred Owners Ass'n v. Roosevelt Raceway Assocs.*, 985 F.2d 102, 104 (2d Cir. 1993)). This requires a showing not only that the defendant's alleged RICO violation was a "but for" cause, but also that the violation was the proximate cause of the alleged harm. *See Holmes v. Securities Investor Protection Corp.*, 112 S. Ct. 1311 (1992). To satisfy proximate or loss causation, the Circuits agree that it is not enough for a RICO plaintiff to allege that but for the misrepresented facts it would not have entered into the transaction. A RICO plaintiff also must allege that the misrepresented facts were the proximate cause "of the transaction's turning out to be a losing one." *See, e.g.*, *Citibank, N.A. v. K-H Corp.*, 968 F.2d 1489, 1495 (2d Cir. 1992); *Bastian v. Petren Resources Corp.*, 892 F.2d 680, 684 (7th Cir.), *cert. denied*, 496 U.S. 906 (1990); *see also Brandenburg v. Seidel*, 859 F.2d 1179, 1190 (4th Cir. 1988). In *Bastian*, for example, the Seventh Circuit, in an opinion by Circuit Judge Posner, refused to allow plaintiffs to proceed on RICO and other fraud claims that would have recovered the difference between what they actually paid for oil and gas partnerships and what they would have paid had they known that the partnership promoters had violated the

securities laws. The court noted that there were other general economic conditions that caused the collapse of the oil and gas market.

Applying these basic rules, the Second Circuit correctly concluded that there was no adequate nexus here. The Bank alleged no facts tying the default on any loan to any of the respondents' alleged misrepresentations. Moreover, the amended complaint showed on its face that the first defaults on the loans occurred only following the crash of the New York City real estate market, several years after the alleged misrepresentations. "[T]he substantial period between the alleged fraud and FNB's loss, coupled with the concurrence of that loss with the real estate market crash, is additional support for the conclusion that the fraud was not a substantial cause of FNB's injury" (Pet. App. A-18).

II

THE DECISION BELOW DOES NOT CONFLICT WITH ANY DECISION OF THIS COURT

The Bank erroneously asserts that the decision below conflicts with *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479 (1985). There is no conflict whatever.

In *Sedima*, this Court rejected a requirement that a RICO plaintiff show independent "racketeering injury." This case has nothing to do with racketeering injury. Far from conflicting with *Sedima*, the decision below actually is based on *Sedima's* instruction that a RICO plaintiff "only has standing if, and can only recover to the extent that, he has been injured in his business or property by the conduct

constituting the violation." Pet. App. A-10 (citing *Sedima*, 473 U.S. at 496).

Nor is there any truth to the Bank's assertion, "that the decision of the Second Circuit will make it virtually impossible for any mortgage lender ever to assert a viable RICO claim" (Pet. 12). As the decision's limiting language makes clear (*see* Pet. App. A-19), the only party affected by this decision is a mortgage lender who, like the Bank, sues in the aftermath of a real estate market collapse on a loan that went into default (i) years after the alleged misstatement, and (ii) coincident with the market's collapse. It forecloses a lawsuit only if the methodology for determining the magnitude of the borrower's misstatement "is so defective, and the conclusions reached so defy logic, that no 'reasonable inferences' [of proximate cause] can be drawn therefrom" (Pet. App. A-17). No court has understood otherwise. Indeed, in the two years since the district court published its first opinion dismissing the Bank's complaint, no court has relied on any of the decisions below to dismiss a RICO claim brought by a mortgage lender.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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